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THE EXCESS PROFITS TAX—PROPOSALS FOR 1941

AFTER a lapse of almost two decades, the Excess Profits Tax Act of 1940 re-creates a form of emergency taxation which was bitterly criticized after the last war.[1] The 1918 Act had scarcely gone into effect when a clamor

1. Title II of the Second Revenue Act of 1940, Pub. L. No. 801, 76th Cong., 3d Sess. (Oct. 8, 1940), INT. REV. CODE §§ 710–52 (1939), enacted the Excess Profits Tax Act of 1940. For a general discussion of this Act see Joint Comment (1940) 50 YALE L. J. 285, 40 COL. L. REV. 1408, 54 HARV. L. REV. 311 (Hereinafter cited as 50 YALE L. J.). The Excess Profits Tax Amendments of 1941, Pub. L. No. 10, 77th Cong., 1st Sess. (Mar. 7, 1941), made extensive changes for the benefit of the taxpayer. Great Britain and Canada have also re-adopted excess profits taxes. Finance (No. 2) Act, 1939, 2 & 3 GEO. VI, c. 109, as amended by Finance Act, 1940, 3 & 4 GEO. VI, c. 29; Excess Profits Act of 1940, (Canada) STATS. of 1940, 2d Sess., c. 32. See BAYLEY AND TAYLOR, THE EXCESS PROFITS TAX (2d ed. 1940) for the text of the British Acts.

arose for its repeal.[2] Taxpayers, writers, and Treasury officials[3] joined in condemning it[4] on the various grounds that it burdened the consumer by raising prices,[5] caused unemployment,[6] penalized efficiency,[7] encouraged extravagance,[8] favored over-capitalization,[9] failed to stop profiteering,[10] and was discriminatory.[11] Even its detractors, however, had to admit that the tax was productive of great revenue during the war.[12] The tax yielded

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Germany and France introduced such taxes even before the war began. See Buehler, *The Taxation of Corporate Excess Profits in Peace and War Times* (1940) 7 LAW & CONTEMP. PROB. 291, 295.

For an outline of excess profits taxes imposed by foreign countries during the World War as well as the text of the British Acts see Legislative Reference Division, Library of Congress, *Taxation of Incomes, Excess Profits, and Luxuries in Certain Foreign Countries* (2d ed. 1921). (Subsequent references unless otherwise acknowledged are taken from this source). The most successful of these taxes was the British tax. See UNDERHAY, INCOME TAX (1922); SNELLING, EXCESS PROFITS DUTY (3d ed. 1917); Haig and Holmes, *The Taxation of Excess Profits in Great Britain* (1920) 10 AM. ECON. REV. (Supp. No. 4).

2. The moderate excess profits tax introduced in America March 3, 1917 was soon superseded by the War Excess Profits Tax Law, Pub. L. No. 50, 65th Cong., 1st Sess. (Oct. 3, 1917) (Hereinafter referred to as 1917 Act). The War Profits and Excess Profits Tax of 1918, Title III of Revenue Act of 1918, Pub. L. No. 254, 65th Cong., 3d. Sess. (Feb. 25, 1919), enacted two different taxes, one for 1918 and another for 1919-20. (Hereinafter referred to as 1918 Act). The latter provisions of the 1918 Act were subsequently extended to 1921 without material change.

3. REP. SEC'Y TREAS. (1919) 23-24, (1920) 38-39, (1921) 21-22. But it should be noted that Secretary Glass distinguished an excess profits tax, which he attacked, from a war profits tax. Secretary Mellon's Report in 1921 criticized the tax as indefensible in time of peace but found it justifiable as a war measure.

4. The 1917 Act was widely condemned as unfair but the 1918 Act had been forecast as a distinct improvement. Seligman, *The War Revenue Act* (1918) 33 POL. SCI. Q. 1, 32; Haig, *The Revenue Act of 1918* (1919) 34 POL. SCI. Q. 369, 382-83; Zoller, *A Criticism of the War Revenue Act of 1917* (1918) 75 ANNALS 182, 189. Secretary of the Treasury McAdoo attacked the 1917 Act for its failure to prevent war profiteering, REP. SEC'Y TREAS. (1918) 46-49.

5. Ballantine, *Some Constitutional Aspects of the Excess Profits Tax* (1920) 29 YALE L. J. 625, 642; Plehn, *British and American Income and Excess Profits Taxes Compared* (Pamphlet published by Continental Ins. Co., 1920) 41; REP. SEC'Y TREAS. (1919) 23-24.

6. 61 CONG. REC. 6093 (1921); *An English Argument for the Withdrawal of the Excess Profits Tax* (1919) 51 CHICAGO LEGAL NEWS 294.

7. See note 5 *supra*.

8. Anderson, *The Excess Profits Tax—Discussion* (1920) 10 AM. ECON. REV. (Supp. No. 1) 27; REP. SEC'Y TREAS. (1919) 23.

9. REP. SEC'Y TREAS. (1919) 23, (1920) 38-39.

10. Plehn, *War Profits and Excess Profits Taxes* (1920) 10 AM. ECON. REV. 283, 293.

11. Ballantine, *supra* note 5, at 642.

12. Typical of the general attitude was the statement, "It (the 1917 Act) was productive of large revenue, but when this favorable statement is made, praise must cease." Haig, *supra* note 4, at 382.

$2,500,000,000 in 1918 alone and $7,000,000,000 over a five year period.[13] A few defended it, principally on the ground that it extended the ability-to-pay principle to corporate taxation.[14]

If these many criticisms are inherently and inevitably valid and any devisable excess profits tax offers no advantages except that it can produce abundant funds for the national treasury in wartime, it would appear better to adopt some other means of producing revenue.[15] But the criticisms of the earlier Act must now be discounted to a large extent since they were made against a peace-time tax in a period when great revenue was no longer needed and when the practice of heavy peace-time taxation of corporations had not yet been universally accepted.[16] The attacks were thus directed against a specific

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*United States**		*Great Britain†*	
1917	$1,843,885,505	1915–16	£188,000
1918	2,505,565,939	1916–17	141,615,000
1919	1,431,805,690	1917–18	223,116,000
1920	988,726,351	1918–19	283,977,000
1921	335,131,811	1919–20	289,208,000
1922	8,466,114	1920–21	218,099,000
		1921–22	29,671,000
TOTAL	$7,113,581,410	TOTAL	£1,185,874,000

*STATISTICS OF INCOME, 1917–1922 (U. S. Int. Rev. Bur. 1919 and subsequent years). The figure for 1917 includes corporations, partnerships, and individuals. The revenue received from corporations alone was $1,638,747,740. The 1922 figure is for fiscal year corporations which paid the 1921 tax later than the others.

† Buehler, *supra* note 1, at 293.

14. Friday, Holmes, and Lyons, *The Excess Profits Tax—Discussion* (1920) 10 AM. ECON REV. (Supp. No. 1) 19, *et seq.* See also *Proceedings of Nat. Ind. Tax Conf.*, April 16, 1920, where a few urged continuance of the tax. Farmers acclaimed the tax as "democratic financing of the war cost" and advocated its continuance. Haig, *British Experience with Excess Profits Taxation* (1920) 10 AM. ECON. REV. (Supp. No. 1) 1; McKenzie, *The Net Income and Excess Profits Should be Kept as the Main Sources of National Taxation* (1921) 95 ANNALS 180, 184. Since farmers approved the tax it is unlikely that it was passed on to consumers.

15. Compulsory distribution or a tax on distributive shares might be used to subject the corporation's income to high personal tax rates, but either plan would cause considerable hardship. A general increase in corporate income tax rates is another possibility but it would be inadvisable because of its relatively heavier burden on those companies not receiving any war profits.

A tax levied solely on war industries would, of course, be more closely correlated with profits arising directly from the war, and still raise some revenue. Congress considered this plan but discarded it because of the difficulty in determining what constituted a "war industry." H. R. REP. No. 2894, 76th Cong., 3d Sess. (1940) 2. (Hereinafter referred to as House Report). Were government contracts taken as a war industries criterion, for example, Douglas Aircraft, a large war profiteer, has shown losses on those contracts and would consequently escape the tax. N. Y. Times, Feb. 24, 1941, p. 26, col. 1.

16. See, especially, *Proceedings of Nat. Ind. Tax Conf.*, April 16, 1920. Professor Adams, who played a prominent part in the administration of the old tax, advocated

tax whose period of usefulness had terminated; they were not, therefore, successful in permanently defeating the general theory of excess profits taxation in war-time.

Premised upon the fact that excess profits taxation will be extensively utilized to meet emergency revenue needs, this Comment intends to consider particularly the excess profits credit adopted by the present Act and to compare alternative credits which might better accomplish the objectives of a war emergency tax[17] — the production of a maximum of revenue without unduly hampering the defense effort, and the restriction of war profiteering.[18]

SELECTION OF THE CREDIT

Since an excess profits tax is levied only on income above a specific credit,[19] the credit is the focal point of the tax and on its selection hinges in large part the success of excess profits tax legislation. Because there are only two general types of credit, the choice lies between one or the other or some combination of the two.[20] The first, an income credit, establishes as "normal" the average earnings of a base period and taxes all increased or "abnormal"

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its discontinuance when the war was over. Adams, *Immediate Future of the Excess Profits Tax* (1920) 10 AM. ECON. REV. (Supp. No. 1) 15; *Should the Excess Profits Tax Be Repealed?* (1921) 35 Q. J. ECON. 363. His disapproval is often cited as the final blow to an excess profits tax. See Hynning, *The Excess-Profits Tax of 1940—A Critique* (1941) 8 U. OF CHI. L. REV. 441, 443. But Professor Adams believed in minimum peace-time taxation of corporations. Adams, *Principles of Excess Profits Taxation* (1918) 75 ANNALS 147, 151.

17. For an article posing the multitude of problems arising in the creation of a sound excess profits tax, see Shoup, *The Taxation of Excess Profits* (1940) 55 POL. SCI. Q. 535; (1941) 56 POL. SCI. Q. 84; to be continued in the June issue. His discussion, however, is prefaced by the statement that he is considering a permanent tax. *Id.* at 535.

18. In his Congressional message calling for an excess profits tax, the President appeared to favor the need for revenue. House Report, p. 2. The Ways and Means Committee, on the other hand, stressed the importance of preventing war millionaires. House Report, p. 1. Secretary Morganthau's statement at the Joint Hearings called for a tax to provide revenue and still not restrict productive activity; but Assistant Secretary Sullivan combined the two purposes, as this Comment does. *Joint Hearings before the Committee on Ways and Means and Committee on Finance on Excess Profits Taxation*, 76th Cong., 3d Sess. (1940) 17, 86 (Hereinafter referred to as Joint Hearings).

19. The tax is levied on adjusted excess profits net income which is computed as follows:

A. "Normal-tax net income" [INT. REV. CODE § 13(a) (2) (1939)].
  B. Additions to "normal-tax net income" [§ 711(a)].
  C. Deductions from "normal-tax net income" [§ 711(a)].
D. Excess profits net income: $D = A + B - C$.
  E. Minus flat exemption ($5,000).
  F. Minus excess profits credit (§ 713 or § 714).
  G. Minus unused credits [§ 710(c)].
H. Adjusted excess profits net income: $H = D - E - F - G$.

20. For a general discussion of different types of credits, see Shoup, *supra* note 17, at 538–543.

profits without regard to whether the base period earnings were low or excessive. The other, an invested capital credit, establishes a "fair" return on invested capital and taxes all "excessive" profits regardless of their normalcy or abnormalcy. The efficacy of either credit or a combination of the two must ultimately be tested by the purposes of excess profits taxation in a war emergency — the production of a maximum of revenue and the restriction of war profiteering.

Although the adoption of an invested capital credit alone might yield considerable revenue, it is nevertheless open to the objection of restricting industrial activity sufficiently to impair the emerging defense effort. A major difficulty in insuring a "fair" return arises from the recognized inadequacy of present theories for determining invested capital. Furthermore, even assuming adequate theoretical standards, a set return on invested capital fixed by legislative fiat for all industries necessarily ignores the difference in the risk factor from industry to industry. Thus, a legislative determination of 8 per cent, for example, as a "fair return" would, in many industries with high investment risks, have the effect of reducing "normal" earnings and consequently result in repelling new capital. The latter objection might be met by establishing a different "fair" return for each industry but the impracticality of such an attempt is readily apparent. In view of these material defects in the invested capital credit, a high tax rate designed to produce large revenue would exaggerate the inequities and hinder industrial efficiency.[21] Furthermore, not only will a flat "fair" return be too low for some industries, but it will be excessive for others. Thus, a company with a low risk factor escapes paying a tax on the difference between the return allowed as a credit and a fair return for the particular industry. Furthermore, a tax using the invested capital credit fails to check war profiteering because "excessive" returns bear little relation to war profits. The steel industry, for example, along with most other heavy industries, is earning at present extensive war profits which, because of low pre-war earnings, would be largely exempt from the tax under an invested capital credit.[22] Consequently, in industries with low normal income, a tax based

21. See Testimony of Chief of Staff Stam of the Joint Committee on Internal Revenue Taxation, Joint Hearings, p. 103, who stated that an equitable excess profits tax could not be based on invested capital alone. See also Ballantine, *War Policies in Taxation* (1931) 9 TAX MAG. 250, 253; Adams, *Excess Profits Tax* in (1935) 5 ENCYC. SOC. SCI. 666.

22. Jones & Laughlin Steel Corp., for example, can probably more than quintuple its average base period income or its 1939 income before being subject to the excess profits tax. Such favorable treatment is undesirable in an emergency tax which is attempting to produce revenue and check war profiteering, but it is sound for a permanent tax. An excess profits tax using an invested capital credit recognizes the fact that there is more value to income than its dollar amount. Income also has value according to its richness — *i.e.*, \$5 earned on a \$10 investment is more valuable than \$5 earned on a \$100 investment. See Ballantine, *supra* note 5, at 625.

on the invested capital credit fails both as a means of producing adequate revenue and as a method of effectively checking war profiteering.

On the other hand, a tax adopting the theory of an income credit appears more nearly to accomplish both purposes of an excess profits tax.[23] Since "normal" earnings[24] would not be taxed under the theory of an income credit, more revenue could be produced by imposing a high tax without seriously impairing industrial efficiency.[25] Thus, a corporation allowed to earn tax-free an amount sufficient for survival in the base period can presumably continue its existence despite a heavy tax on increases in income.[26] An income credit, in addition, can be more accurately determined than the invested capital credit because of the ready availability of income figures and the greater ease of foreseeing and providing for unusual profits or losses. Although an income credit may not establish "normal" earnings accurately in all cases because of the cyclical position of a particular company, the error will probably apply to the whole industry without discrimination among competitors within the industry. The application of the tax to abnormal income only and the greater accuracy of an income credit would, therefore, permit raising the tax to even 100 per cent without unduly hampering the

23. In 1918, the Treasury was dissatisfied with the invested capital credit of the 1917 Act and sought to have an income credit adopted. See Ballantine, *supra* note 21, at 252; 1918 Report of Secretary McAdoo, *supra* note 4.

24. Since income taxes are deducted both in the base period and in taxable years, the normal income will not be diminished by higher corporate income taxes. Every corporation retains the $5000 flat exemption as well as the normal income exemption.

25. The 1917 Act which used an invested capital credit (7-9%) was attacked on the ground that little business was more heavily taxed than big business. *Report of the Committee on War Finance* (1919) 9 Am. Econ. Rev. (Supp. No. 2) 16. Congress had, however, adopted the invested capital credit only after a long and bitter battle and did so because the largest business enterprises had been making high pre-war profits. Adams, *supra* note 16, at 153. Seligman, *supra* note 4, at 25. It is difficult to state a general rule but little business is probably less burdened under an income credit.

Small companies will never be severely hurt under either credit since they always receive the flat exemption. The exemption also serves as a buffer against discrimination in favor of partnerships which are entirely exempt from the tax. Since the 1940 Act allows $5,000 [§ 710(b)(1)] small corporations receive substantial increases in their credits. It has been estimated that this exemption will limit the application of the tax to about 70,000 out of 500,000 active corporations. *Hearings before Senate Comm. on Finance on H. R. 10413,* 76th Cong., 3d Sess. (1940) 119, 203. (Hereinafter referred to as Senate Hearings). Since administration of the tax would be impossible if it were applied to all corporations, some flat exemption is necessary but it should be as low as administratively practicable because experience in the last war showed that little corporations reaped enormous war profits, ranging almost as high as 5,000%. Sen. Doc. No. 259, 65th Cong., 2d Sess. (1918). The $3,000 exemption allowed in the last war is probably proper. 1917 Act, § 203; 1918 Act, §§ 311(a)(1), 312.

26. The income credit recognizes the different risk factors in industries since the company is permitted to earn free from tax its base period average which should approximate in most cases the return required because of risks in the industry.

defense effort.[27] Furthermore, the income credit checks corporate war profiteering because it taxes the increases in income over those of the pre-war period. The defense and war boom will not cause *all* increases in income but the increase so measured is the closest available approximation to war profits.[28]

Yet an income credit, although superior to the invested capital credit, is not completely adequate. The hypothesis that increases in income result from the war boom applies to all corporations, but its application for the purpose of taxing companies with very low base period earnings would be oppressive. On the other hand, the income credit favors corporations with high base period earnings by virtually guaranteeing their "excessive," and even monopolistic, profits. Although under the strict theory of a war profits tax — that is, a tax using an income credit — normal income should not be taxed, the revenue needs of the government require some tax on the high profits.

If neither tax is adequate by itself, perhaps some combination will eliminate the weaknesses and retain the advantages of each. The Excess Profits Tax Act of 1940 combined the two by allowing the taxpayer his option of either the income credit or the invested capital credit.[29] Those corporations earning less than 8 per cent on current invested capital in the base period

27. Great Britain has a 100% rate now. Finance Act, 1940 § 26. A 100% tax was proposed in Canada but a 75% rate was adopted. Excess Profits Act of 1940, § 3. See Rothney, *Parties and Profits* (1940) 20 CANADIAN FORUM 204. The British tax rate has been attacked but it is unlikely that it will be lowered for political reasons. *E. P. T. Examined* (1940) 139 ECONOMIST 552, 581-82; 137 STATIST 116-17 (1941). In 1935 and 1936 a 100% rate of tax for wartime was passed by the House and given serious consideration in Senate Committees. H. R. 5529, 74th Cong., 1st Sess. (1935); *Hearings before a Subcommittee of the Committee on Finance on H. R. 5529*, 74th Cong., 2d Sess. (1936).

28. Justification for heavy taxation of war profits is found in the theory that the Government is simply retaking part of the profits created by its own activity. See Adams, *supra* note 16, at 154.

29. Section 712(a). See also § 741 (certain reorganizations); § 712(b) (foreign corporations). Companies not specifically granted the election are required to use the invested capital credit. Every company must compute both credits in its return unless one is expressly disclaimed. § 712(c).

Canada originally gave the taxpayer an election between two credits but soon changed to an income credit alone. See SEN. REP. No. 2114, pt. 2, 76th Cong., 3d Sess. (1940) 10-11 (hereinafter referred to as Minority Report).

In recommending an alternate credit the House Subcommittee optimistically declared, "The plan recommended by your subcommittee combines what your subcommittee believes are the best elements of each of these fundamental excess-profits tax concepts." Report of a Subcommittee of Committee on Ways and Means, *Proposed Excess-Profits Taxation and Special Amortization*, 76th Cong., 3d Sess. (Aug. 8, 1940) 3. (Hereinafter referred to as Subcommittee Report). An alternative credit continued through Congress although Senator LaFollette persistently championed an invested capital credit alone. Minority Report, p. 9.

may select the invested capital credit and exceed "normal" earnings up to 8 per cent without paying the tax.[30] Companies earning high profits during the base period, on the other hand, may elect the income credit and earn excessive income tax-free until the income credit is exceeded.[31] Thus, unless the two are equal, the purpose of neither credit is satisfied, because many corporations earn more than "normal" income and others earn more than a "fair" return without being taxed. Although other countries do not currently allow optional credits,[32] legislation during the last war serves as precedent for the present provision.[33] But the optional credit, leaving war profiteering unchecked and providing negligible revenue, unduly discriminates against the government in favor of the taxpayer.[34]

30. The failure of Congress to tax all "abnormal" profits — *e.g.*, the steel industry — has been especially attacked. See 104 NEW REPUBLIC 4-5 (1941) which exhorts Congress to eliminate the invested capital option so that the "war's greatest corporate beneficiaries" will pay.

The carry-over of unused credits for two years [§ 710(c)] may permit still greater increases in normal income without additional tax in some cases. Since many steel companies earned extensive war profits in 1940 without reaching 8% of invested capital, their invested capital credits will be even greater for 1941. A carry-over provision is necessary to take care of the "feast or famine" corporations which normally earn high profits in one year to offset losses or low earnings in other years. The British Act in the last war properly carried unused credits both forward and backward by a method of averaging. Finance (No. 2) Act, 1915, § 38(3) through Finance Act, 1920, § 44(2). Although a carry-over is necessary, it should apply only to the base period average earnings since a carry-over of the invested capital credit or a minimum income credit expressed in terms of invested capital would extend special relief unduly.

31. Hynning, *supra* note 16, at 468, attacks the present option given to taxpayers because the income credit favors corporations with high or monopoly profits which he feels should not be given a tax premium. He favors the use of an invested capital credit alone with a limit on invested capital so that it will not be greater than an amount of which the base period experience makes up 2 or 3% (at 470). It should be noted, however, that Hynning prefaces his proposals by stating that he is primarily concerned with a permanent tax (at 466). The Twentieth Century Fund also has recommended a permanent excess profits tax with an invested capital credit in order to check monopolies. TWENTIETH CENTURY FUND, FACING THE TAX PROBLEM (1937) 409, 492.

32. Great Britain has an income credit alone, having omitted the 6% minimum of the last war. Canada has an income credit alone. See Minority Report, pp. 10-11. Germany's pre-war tax used an income credit while that of France used an invested capital credit alone. See Buehler, *op cit. supra* note 1, at 295.

33. 50 YALE L. J. 285, 290 refers to the present Act as "unique in giving the taxpayer an annual choice between two methods." The same thing was done in the last war by calling it a minimum instead of an alternative credit. Great Britain had a minimum of 6% of invested capital for corporations (9% for new corporations), Australia 10% for new companies, Germany 6%, Austria 6%, France 8%, Union of South Africa 8%, and New Zealand 7½%.

34. According to the budget estimates the present Act with its optional credit will yield only $160,000,000 for the fiscal year 1941 and $522,000,000 in 1942. U. S. GOV'T BUDGET, FISCAL YEAR ENDING JUNE 30, 1942 (U. S. Budget Bur. 1941), A3. This yield is indeed small when it is remembered that corporate net income was probably 20 to 25%

Reversing the option between the two credits to favor the Government instead of the taxpayer is perhaps the most apparent change that might be made. Two tax schedules, as in the 1918 Act, might be used: one with an invested capital credit and a tax graduated by degrees of excessiveness, and the other with an income credit and a flat tax.[35] The taxpayer would be required to pay the higher of the two taxes. A minimum of about 4 per cent or 5 per cent of invested capital would have to be set for the income credit since a lower minimum or no minimum with the full tax rate would bear too harshly on the company with low base period experience. Since virtually all companies would be subject to one of the alternative taxes considerable revenue would be produced — the companies with low base period earnings would pay one tax and those with high base period earnings would pay the other. It would also check war profits because low earning companies would pay a tax on increases in their incomes and high earning companies would pay a tax both on increases in income and on their already high earnings.

The Treasury originated a similar plan[36] to use the average income credit alone but confine it within the limits of a minimum and maximum expressed in terms of invested capital, *e.g.*, 4 or 5 per cent and 10 or 12 per cent. The imposition of the same tax rate on all corporations distinguishes this plan from that used in the 1918 Act. Levying the full tax rate rather than a graduated tax on all income over the maximum causes the tax to fall more heavily on high earning corporations. While possessing the advantages of the 1918 plan, the Treasury proposal has the disadvantage of taxing "excess" profits at the same flat rate applied to "war" profits.[37]

The failure to correct fully the inadequacies of either credit alone lessens the desirability of both the 1918 plan and the Treasury plan. The following

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higher in 1940 than in 1939 and should be substantially greater in 1941. N. Y. Times, Feb. 21, 1941, p. 31, col. 3. It has been estimated that the revenue will diminish by $100,-000,000 annually because of the 1941 Amendments. N. Y. Times, Feb. 28, 1941, p. 20, col. 3.

35. The 1918 Act imposed an Excess Profits Tax and a War Profits Tax for the year 1918 and the taxpayer was required to pay the larger of the two. § 301(a). The excess profits credit was 8% of invested capital (§ 312) and the tax was graduated by degrees of excessiveness with the tax applied in two brackets at rates of 30 and 65% [§ 301(a)]. The war profits credit was average pre-war income plus or minus 10% of the capital change (§ 311) and the tax was at a flat 80% rate [§ 301(a)]. However, the minimum income credit was set at 10% [§ 311(b)] which was so high that in most cases both taxes had an invested capital credit. See Ballantine, *supra* note 21, at 253.

36. This is somewhat different from the Treasury's proposal, as adopted by the House Subcommittee, since the latter averaged the returns earned each year during the base period rather than only the dollar amounts of income. Subcommittee Report, pp. 10–11. The Subcommittee called this an invested capital credit. It can be considered as a flexible invested capital credit but it is treated here as a controlled income credit.

37. Instead of a flat tax, the tax might be graduated by percentages of the credit. The Subcommittee Report, p. 10, recommended such a graduated tax. A high flat tax, however, will more effectively produce revenue and check war profiteering.

method may prove to be a theoretically sounder scheme for an emergency tax:[38]

(1) If the company's income credit is 8% of the taxable year's invested capital, or less, apply the following schedule to income *in excess of the income credit:*

Return Earned on Invested Capital During the Taxable Year	*Tax*
0–2%	None
2–5%	20%
5–8%	40%
over 8%	60%

(2) If the company's income credit is greater than 8% of the taxable year's invested capital:

(a) Apply the following to income *less than the income credit:*

Return Earned on Invested Capital During the Taxable Year	*Tax*
8–12%	20%
over 12%	40%

(b) Apply a tax of 60% on income in excess of the income credit.[39]

38. The tax rates and percentages of invested capital are tentative and are selected merely for illustration. In conjunction with the income tax rate of 24%, the total impact of the 20% rate would be 39.2%, of the 40% rate 54.4%, and of the 60% rate 69.6%. The method proposed is similar to Carroad's "Twilight Zone Excess-Profits Tax Proposal" except that his proposal called for a flat 4% tax instead of the 20 and 40% taxes. Senate Hearings, pp. 41-3.

39. TAX PAID BY A CORPORATION WITH INVESTED CAPITAL OF $1,000,000:

Income Credit		*Earned During the Taxable Year*							
		Dollars	$20,000	$50,000	$80,000	$100,000	$120,000	$150,000	$250,000
Dollars	*Return*	*Return*	2%	5%	8%	10%	12%	15%	25%
$10,000	1%		0*	$6,000*	18,000*	30,000	42,000	60,000	120,000†
$40,000	4%		0*	2,000*	14,000*	26,000	38,000	56,000	116,000
$60,000	6%		0*	0*	8,000*	20,000	32,000	50,000	110,000
$80,000	8%		0*	0*	0*	12,000	24,000	42,000	102,000
$100,000	10%		0*	0*	0*	4,000*	16,000	34,000	94,000
$150,000	15%		0*	0*	0*	4,000*	8,000*	20,000*	80,000‡

* The present Act would levy no tax at these points.

† This tax is computed as follows:

(1) Even though the corporation increased its earnings, there is no tax on the first $20,000 because of the 2% exemption.
(2) The next $30,000 (2-5%) is taxed at 20% $6,000
(3) The next $30,000 (5-8%) is taxed at 40% 12,000
(4) The balance of $170,000 (over 8%) is taxed at 60% 102,000

$120,000

‡ This tax is computed as follows:

(1) The first $80,000 is exempt (8%).
(2) The next $40,000 (8-12%) is taxed at 20% $8,000
(3) The next $30,000 (12-15%) is taxed at 40% 12,000
(4) The balance of $100,000 (over 15%) is taxed at 60% 60,000

$80,000

The reasons for the selection of this plan are threefold: First, as indicated previously, an income credit appears more suited to the present emergency. Secondly, the possible oppressiveness of an income credit requires special treatment for companies with low or no base period earnings. If a minimum credit is set it cannot be very low — probably not lower than 4 or 5 per cent of invested capital — because the full tax rate applies to all income above the minimum. A high minimum permits many war profits to go untaxed and cuts off a source of revenue. Since companies can afford to pay some tax on all increases in income, it seems more expedient to impose a tax on companies with low earnings in the base period, but at a lower rate. Finally, high-earning companies also require special treatment because an income credit favors them over low-earning competitors and leaves untapped a large source of revenue. A maximum credit might be set leaving all income above the maximum subject to the full tax. It would be unnecessarily severe, however, to levy the full war profits tax rate on "normal" income merely because — perhaps through an error in computing invested capital — it exceeds an arbitrary standard of "excessiveness." If the tax were raised in the future to 100 per cent it would become extremely oppressive on some companies. The full tax should, therefore, be applied only to income in excess of the income credit, taxing income between 8 per cent of invested capital and the income credit at a lower rate.

The last proposal, at first appraisal, however, appears to depend too substantially on invested capital to be practicable. But because the full tax rate applies only to income in excess of the income credit or 8 per cent of invested capital, whichever is higher, the use of invested capital will cause less hardships than under the Treasury and 1918 plans by allowing the taxpayer to receive at least its "normal" income before being subject to the full tax rate.

Both the credit used in the 1918 Act and that proposed by the Treasury, as well as that suggested above, would be preferable to the option given to the taxpayer by the present Act. Either the income or invested capital credits by themselves would also be better than the existing scheme. Although the third plan, and to a less degree the other two, should satisfy the needs of an emergency excess profits tax, the selection of a theoretically sound credit is but the first step in formulating a successful tax. Numerous additional problems inherent in both of the credits must still be solved if the theory of an income credit controlled by invested capital is to become workable.

INCOME CREDIT

The practical application of any theory of tax credit based on income requires the development of a standard for measuring "normal" earnings. Whether future legislation maintains the taxpayer's option granted by the present Act or adopts the preferable scheme of an income credit controlled by capital investment, an evaluation of the methods of computing "normal" income remains a central problem in the formulation of a sound tax.

The accepted method for determining normal earnings requires a comparison of present income with that earned during a "base period."[40] Changes in the amount of capital investment, however, render the exclusively empirical test of earnings during a prior period an inadequate measure of present normal income. In an effort to compensate for the obvious discrepancy, the 1940 Act provides for an increase in average base period net income to the extent of 8 per cent of the net capital addition for the taxable year, and for a decrease by 6 per cent of the net capital reduction.[41] Because more remote years tend to reflect present normal earning power less accurately, the Act adopts as the base period the four years immediately prior to the first year in which the tax is imposed. But since the base period is more precisely defined as the four "taxable" years beginning after December 31, 1935, and before January 1, 1940, the base period prescribed for a particular company depends, in effect, on whether it ordinarily uses a fiscal or calendar year as a basis for computing taxable income.[42] Thus, fortuitously, a company on a fiscal basis enjoys the benefits of defining its "normal" earnings for the purposes of the credit partially in terms of income during prosperous months of 1940. An extreme example of the resulting competitive inequities may be found in the case of the Douglas Aircraft Company which, under the Act, includes in its base period, ending with its fiscal year on November 30, eleven of the abnormal months of 1940 instead of the corresponding months of 1936. Subject to the 50 per cent tax in the top bracket, Douglas will save approximately $1,250,000 annually in the amount of the tax paid.[43] Since the majority of companies in the

40. The present Act is unique in allowing only 95% of average base period earnings. § 713(a)(1)(A). The explanation is that Congress was extremely wary about granting the income alternative. As passed by the House, corporations electing this alternative were required to pay an additional tax of 4.1% on normal-tax net income and an additional 5% in each excess profits tax bracket. House Report, p. 9; H. R. REP. No. 3002, 76th Cong., 3d Sess. (1940) 42 (Hereinafter referred to as Conference Report). The recent Treasury tax proposals suggested a further reduction in the percentage of earnings allowed for the income credit from 95% to 75%. N. Y. Times, April 23, 1941, p. 16, col. 2. In conjunction with this there would be a reduction from 8 to 6% in the invested capital credit. These changes would, of course, increase revenue but the unsound alternative credit is retained when a complete change would be more desirable.

41. § 713(a)(1). Foreign corporations use average earnings only without correction for capital additions and reductions. § 713(a)(2). Neither accumulated earnings and profits, even if capitalized by a stock dividend, nor borrowed capital can be included in capital additions since the latter is limited to equity capital paid in. § 713(g)(3). A dividend declaration followed immediately by reinvestment by the stockholders would serve as a possible subterfuge to increase the income credit. See Seidman, *The New Excess Profits Tax* (1940) 18 TAXES 659, 701.

42. § 713(b)(1)(A). For the definition of "taxable year" see INT. REV. CODE § 48 (1939).

43. Douglas' earnings averaged about $2,000,000 for the four years ending November 30 from 1936 through 1939 which would give it a credit comparable to that of its

aircraft industry will select income instead of invested capital as the basis for the credit, the Act operates to create substantial competitive inequality within the industry.[44] Following the precedent of the 1918 Act,[45] the defect of the present Act in failing to preserve pre-existing competitive relationships might be cured by pro-rating base period earnings so that companies on a fiscal basis include an aliquot part of their income for the initial and final fiscal years in a base period of four calendar years.[46]

Where normal earnings for the year in which the tax is imposed are computed by obtaining an arithmetic average of base period income, years in which the taxpaying company suffered a loss have the effect of diminishing the amount of normal earnings and correspondingly increasing the tax burden. In computing the base period income, loss years may be treated in one of three ways — they may be included as minus quantities,[47] one or more of them may be counted as zero, or the taxpayer may be permitted to select a certain number of years in the base period for the purposes of the credit.[48] Since presumably losses are as normal as profits, an algebraic sum of the base period earnings appears most adequately to approximate "normal" income. A computation by the last method, however, minimizes the effect of prior losses on the amount of the tax by excluding poor years. By allowing the inclusion of one loss year as zero, the present Act represents a compromise between the two conflicting policy considerations.[49]

competitors. But the company netted $10,832,000 for the year ending November 30, 1940, after taxes and after a deduction of $818,000 for further expected losses on government contracts. N. Y. Times, Feb. 24, 1941, p. 26, col. 1. Since eleven-twelfths of this much larger income is substituted in the base period for eleven-twelfths of its $1,000,-000 1936 income, the average income is increased by about $2,500,000. It is little wonder that Douglas stock rose immediately after passage of the Excess Profits Tax of 1940. TIME (Oct. 28, 1940) 71.

44. On the other hand, the fiscal year corporations in the paints and varnishes industry will be at a comparative disadvantage because 1940 was a less profitable year for that industry than 1936.

45. 1918 Act, § 310.

46. Similarly the fiscal year corporation escapes the tax for part of the 1940 calendar year. It will pay the tax after calendar year corporations have finished paying but that will probably be a post-war depression year.

47. France used an average of three years in the last war which required a deduction of losses from the total base period income before averaging. Canada uses an average of all four years 1936 through 1939 in the present war. Excess Profits Act of 1940, § 2(1)(h).

48. In Great Britain during the last war, the taxpayer was given his option of the best two of the three pre-war years and if those three years were abnormal depression years (defined to mean where the average earnings were 25% below average income of the three preceding years) an average of any four of the six pre-war years could be used. In the present war the British base period is 1935 or 1936 or either one with 1937, but not 1935 and 1936 together nor 1937 alone. Finance (No. 2) Act, 1939, § 13. Germany and Austria in the last war used an excellent method to find normal income since they averaged three of the five pre-war years, excluding the best and the worst.

49. § 713(e). The inclusion of the greatest loss year as zero follows the example of the 1918 Act, which allowed all loss years to be included as zero. § 320(b). This is the

Since recession years, as for example 1938, may be included in the base period, a special concession for loss years may be justified. A straight average of the income for all of the years of the base period, however, has the distinct advantage of maintaining the competitive differences among individual companies of the same industry. A mitigation of the increased tax burden resulting from prior losses might be more directly accomplished by an appropriate selection of lower tax rates.

Ascertaining present normal income on the basis of prior earnings also presents peculiar problems where the taxpaying company was in a process of expansion over the base period. In a company with a growing capital investment where dollar income during the base period has increased but a constant rate of return has been maintained, it is obvious that average base period earnings only roughly approximate present normal income.[50] The 1941 Amendments to the Act attempted to meet objections to the use of a straight average by adopting, as an alternative, a simple but grossly unreliable statistical method of forecasting an income trend between two periods.[51] In effect, the adopted method provides that one-half of the difference between the aggregate income of the first two years and the second two years of the base period be added to the aggregate income of the second two years. One half of the resulting amount becomes the income credit, although under the Act it cannot be larger than the earnings of the most favorable base period year.[52] Because of the impossibility of accurately projecting income trends on the basis of four years of corporate history the method adopted by the Amendment seems a substantially ineffective device for measuring the present normal income of the expanding company.[53]

House version, while the Senate version provided for an average of the best three of the four years. Conference Report, pp. 47-48. Representatives of both the Treasury and the Joint Committee recommended the average of three of the four years, but the Ways and Means Committee turned it down because it would mean a loss of revenue. Testimony of Assistant Secretary Sullivan and Chief of Staff Stam, Senate Hearings, pp. 143, 193.

50. Philip Morris & Co. is an example of a company which was continually growing in size throughout the base period. A straight average of the four base period years would result in an average which was normal two or three years ago but which is now entirely unrepresentative of normal income. The whole aircraft industry is in a similar position.

51. § 713(f). The average of the second two years must be higher than that of the first two years in order to use this method of averaging. Loss years are included as minus figures.

52. Since Congress recognized the fact that the advantage of the fiscal year corporation would be further exaggerated under this alternative method of averaging, income received after May 31, 1940, by a corporation whose fiscal year ends after that date is excluded in a roundabout way. § 713(f)(7). A large part of the advantage of the fiscal year corporation, however, is retained. Douglas Aircraft will have approximately the same credit under either method of averaging, but the other corporations will not receive enough of an advantage under the new method to remove their competitive disadvantage.

53. Corporations which were not in existence during the whole of the base period are also permitted to select this method of averaging. § 713(d)(2). The forecast thus becomes even less accurate in such cases.

Stripped of its complicated verbiage the provision operates merely to allow the taxpayer the option of selecting the last two years of the base period for the purpose of computing normal income with a credit bonus if the first two years were comparatively unproductive.[54] Not restricted by its terms to growth companies, it apparently makes available to all taxpayers an alternative base period less adequate because of its brevity without properly treating the problem of the expanding company.[55]

Because of practical administrative difficulties the ideal scheme for computing the normal income of an expanding company probably cannot be regarded as feasible. Theoretically, a company should perhaps be permitted in a taxable year to earn tax-free the same rate of return on its invested capital as that earned on different amounts of capital in the base period.[56] Averaging returns, however, necessarily requires the burdensome computation of the amount of capital investment for each of the base period years.[57] A simpler method than averaging rates of return and a sounder method than forecasting income trends may be found in the use of a weighted average of the base period earnings of growth companies so that each year in the period is given more weight than its predecessor. Limited to companies successfully sustaining the burden of proving to the Commissioner that they are expanding enterprises, the weighted average has the practical effect of giving multiple significance to the more recent earnings of the growing company without necessitating a computation of base period capital investment and without relying on the doubtful accuracy of questionable trends.[58]

Special dispensation is further required under an income credit for determining the normal income of new companies which were in existence during

54. Because of the bonus, the credit in most cases will be the 1939 income.

55. Barron's expects little relief from the new method of averaging because 1938 was a poor year for most corporations. See BARRON'S (March 3, 1941) 18. But this view is probably unduly pessimistic.

56. This is similar to the original proposal of the House Subcommittee for an invested capital credit which would allow the same rate of return in the taxable year as in the base period, but not less than 4% nor more than 10%. Subcommittee Report, p. 3. The House adopted this method with the minimum raised to 5%, but the Senate substituted the final version which eliminated references to base period earnings in determining the invested capital credit. Conference Report, pp. 48-9. The income credit never made any reference to rate of return.

57. Another basic weakness of averaging returns is that the income credit would be changed by a capitalization of earnings through a taxable exchange or sale of the business. The dollar amount of the income credit would thus be increased or decreased as a result of changes in value of the same invested capital between the two periods when the percentages are retranslated into dollars in the taxable year.

58. A somewhat similar problem is presented by the liquidating company. The present Act permits a corporation to transfer to another all or part of its assets and still keep its income credit while the acquiring corporation gets the credit also. See 50 YALE L. J. 285, 299. This loophole was pointed out in the Minority Report (p. 4) but Congress did nothing about it. A weighted average could apply to such companies as well as to expanding companies.

only part of the base period. These new companies might be allowed to base normal earnings on the average income of the period of their existence,[59] or they might be required to substitute the invested capital credit.[60] As a third possibility, the base period could be completed by using a percentage of invested capital for that part of the period when the corporation was not in existence. By adopting the latter method, the present Act arbitrarily ascribes 8 per cent of invested capital at the beginning of the 1940 taxable year to the earlier months of the base period.[61] Since, however, a new company which earned less than 8 per cent will use the invested capital credit option under the Act, the present provision applies only to, and reduces the average earnings of, the new company earning more than 8 per cent during its period of existence. This provision is probably a recognition of the fact that 1939 was a good year for business in general, and for war industries in particular, so that an average of earnings for the short period in existence would tend to favor new companies over competitors which had to average earnings for the whole period of 1936 through 1939. However, since there are few new companies which are immediately so successful,[62] the brake on average earnings is probably unnecessary and an average merely of earnings for the period in existence would better fit the purposes of the income credit.[63]

Invested Capital Credit

The most vexing problem connected with the invested capital credit is valuation of the corporation's assets.[64] The Excess Profits Tax of 1940 uses the "basis (unadjusted) for determining loss upon sale or exchange"[65]

59. This is the method that was used in the 1918 Act. § 310.

60. The proposal of the House Subcommittee denied the income credit option to corporations not in existence for the entire base period so that they would have to use the invested capital credit. Subcommittee Report, p. 10. The House adopted this plan but the Senate adopted the version which finally became law. Conference Report, p. 47.

61. § 713(d)(2).

62. A new company which is a subsidiary of a pre-existing corporation might earn large profits from its beginning but if consolidated returns are used, as recommended, these profits would be averaged with other profits of the affiliated corporation going back to 1936. See note 101 *infra*.

63. A company coming into existence after the expiration of the base period cannot use an income credit. Some percentage of invested capital must be substituted for its credit.

64. For general discussion of valuation problems see Shoup, *supra* note 17, at 548 *et seq.* Valuation in Great Britain is approached from the asset side of the balance sheet whereas a back-handed approach from the liability side is used in the American acts. *Id.* at 554-55. For a discussion of the invested capital credit in the present Act, see 50 YALE L. J. 285, 291-95; Phillips, *Excess Profits Credit Under the Invested Capital Method* (1941) 71 J. ACCTY. 20; Funk, *Equity Invested Capital at the Beginning of the Taxable Year* (1941), *id.* at 241.

65. § 718(a)(2). For determination of basis, see INT. REV. CODE § 113(a)(6) (1939).

which means that invested capital is computed at original cost plus taxable gains and minus taxable losses.[66] Since the Treasury already has these figures on hand for other purposes,[67] this method is comparatively simple. But interference of many chance factors will frequently cause unfairness in values thus found.[68] An alternative method of valuation would be appraisal value either at the time the tax went into effect,[69] or for each taxable year, or at any past time;[70] but the immense administrative burden renders it unfeasible.[71] Still another valuation formula is the cost to the present holder, whether or not the gain or loss was taxable.[72] This might be the best method

66. But see §§ 718(a)(5), 718(b)(4) for liquidation of subsidiaries. INT. REV. CODE § 112(b)(6) (1939).

67. Especially for determining gains or losses on sales and exchanges and for computing depreciation. This will alleviate many of the difficulties existing during the World War when data was not so available. See Hynning, *supra* note 16, at 470.

Determination of invested capital caused much litigation under the former acts and some of these cases are still pending. Joint Hearings, p. 104. *E.g.*, British American Oil Co., Ltd. v. United States, N. Y. Times, Mar. 30, 1941, § 3, p. 1, col. 5 (S. D. Cal. 1941), which involved determination of invested capital under the 1917 and 1921 Acts. The elimination of distinctions between tangible and intangible property, the omission of references to "par value," and the substitution of "earnings and profits" for "earned surplus" are expected to cause less litigation under the present Act. Joint Hearings, pp. 94-95.

68. Any cost method of valuation creates many inequalities between competitors since differences will result depending on the price level at the time a factory was acquired, whether or not the company had been conservatively capitalized, and whether good will or other intangibles were capitalized, etc. § 733 was added by the 1941 Amendments in order to permit capitalization of base period expenditures for advertising and good will which had not been previously capitalized so that differences in past treatment are lessened. The basis creates added opportunity for inequality depending on whether the company had gone through a taxable or tax-free exchange and, if taxable, whether the price level was low or high. If there was a tax-free gain a corporation gets a smaller invested capital than it actually paid and if there was a tax-free loss it gets a larger invested capital than it actually paid. In defense of adding taxable gains, but not tax-free gains, to the invested capital it can be said that companies which have been taxed for gains have paid for the privilege. They paid at a low income tax rate in the past, however, and within a few years under the excess profits tax they will recoup more than the amount of the tax formerly paid.

69. See Adams, *supra* note 16, at 157. Failure to use the value of property at the time the law became effective was attacked in the last war on the ground that it deprived the taxpayer of income arising from appreciated value. McCamic, *Appreciation in Value as Invested Capital Under the Excess Profits Law* (1921) 30 YALE L. J. 239, 249. But see LaBelle Iron Works v. United States, 256 U. S. 377 (1921) (validity sustained).

70. See SHOUP, *supra* note 17, at 553, for the suggestion that the taxpayer be given the option of selecting a valuation period of ten years before the act.

71. Current appraisal is unsound on a theoretical level as well. It results in capitalization of earnings when the real objective is separation of invested capital from earnings. Invested capital would consequently reflect income so that high earnings would seem lower and vice versa.

72. The 1918 Act used cost to the present holder. § 326(a). But in cases of reorganizations after March 3, 1917, where stockholders of old companies retained 50%

if the straight invested capital credit was selected; but when invested capital is used only to control the income credit; it might be better to evaluate assets on the basis of their worth to the original holder. Since exchanges and sales are generally made at prices which capitalize earnings, the purpose of using invested capital to control the income credit would be defeated unless invested capital was completely divorced from earnings.[73] But cost to the original holder also has its disadvantages since it may be so remote in some cases that it will be inequitable.

It is impossible to devise a perfect method for valuing invested capital. For administrative reasons, some method involving cost must be selected but the use of cost necessarily introduces inequities in certain cases. The goal must be to reduce these cases of inequities to a minimum. Because it is simplest the basis may prove to be the best method. A combination of methods as by averaging the basis and the cost to the original holder or an average of the cost to the present and original holders might cancel out errors inherent in any of these methods alone. It is only by a study of corporate tax returns that a definite decision can be made. The ultimate solution of the valuation problem will depend in large measure upon the success with which the present scheme operates.

Associated with the problem of how to evaluate assets for purposes of the invested capital credit is the question of what items should be included. Under the present Act invested capital is the sum of equity invested capital plus one-half of borrowed capital reduced by an amount for inadmissible assets.[74] In the last war[75] borrowed capital was completely excluded from invested capital, but this treatment was widely attacked[76] and necessitated special relief in many cases.[77] The reason for including borrowed capital in invested capital is to help small companies which have difficulty in obtaining equity capital.[78] Congress chose to allow inclusion of one-half of bor-

control in the new company, value was considered to be not more than the cost to the predecessor (§331).

73. Gains in sales or exchanges after December 31, 1941, should not be permitted to increase the invested capital. Such a sale or exchange would most certainly be at a price to capitalize large profits earned during the emergency period and the whole purpose of using invested capital would be defeated.

74. §§715-720. Invested capital is not limited to capital used in the business. Although such a limitation is desirable, the difficulty of distinguishing between capital used in the business and other capital bars its use. No provision is made for rented capital instruments which, in many cases, are substantially the same as owned instruments.

75. §326(b). Interest, of course, was a deductible expense. §234(a)(2).

76. Reed, *Observations on the War Excess Profits Tax* (1918) 50 CHICAGO LEGAL NEWS 192; Holmes, *The Excess Profits Tax—Discussion* (1920) 10 AM. ECON. REV. (Supp. No. 1) 23.

77. Empire Fuel Co. v. Hays, 295 Fed. 704 (N. D. W. Va. 1924); Johnson *et al.* v. United States, 37 F. (2d) 778 (Ct. Cl. 1930); Hind v. Commissioner, 66 F. (2d) 430 (C. C. A. 9th, 1932).

78. The House bill provided for the inclusion of borrowed capital on a sliding scale basis depending on the amount of the borrowed capital and the amount of equity invested

rowed capital in invested capital and disallow one-half of the deduction for interest.[79] This results in giving the benefit in inverse proportion to the need.[80] Because of the substantial tax saving[81] large corporations could actually profit by borrowing money and never using it. If it is desired to give corporations something more than the deduction for interest,[82] the approach should be made through the interest since the cost of the capital is the important factor. The companies in need of aid are the small ones and those with a high percentage of borrowed capital because they must pay heavy interest charges. The best way to help them would be to allow the full deduction for interest and add to the credit one-half of the interest charge with a maximum of 8 per cent for the interest deduction and the additional credit. Under this scheme companies paying the most interest would receive the greatest benefit.[83]

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capital. House Report, pp. 10-11; Subcommittee Report, p. 5. This graduated scheme was intended to give small companies the greatest benefit. Joint Hearings, p. 71.

79. §§ 719, 711(a)(2)(B). This is the Senate plan which was adopted in conference instead of the House plan. SEN. REP. No. 2114, 76th Cong., 3d Sess. (1940) 14 (Hereinafter referred to as Senate Report); Conference Report, pp. 49-50. Borrowed capital was not included in full because it was feared that over-expansion would be encouraged. Joint Hearings, p. 71.

80. In the absence of any provision for borrowed capital, companies would still have a deduction for interest. INT. REV. CODE § 23(b) (1939). The present Act gives a greater deduction than this. If a company borrows at 6%, it would get a combined credit and deduction of 7% ($\frac{1}{2} \times 6\% + \frac{1}{2} \times 8\%$) for an increased benefit under the Act of just 1%. However, if it is a large corporation which can borrow at 2%, it gets 5% ($\frac{1}{2} \times 2\% + \frac{1}{2} \times 8\%$) thus gaining 3% under the Act.

81. A corporation in the 50% excess profits tax bracket may borrow $100 at 1% and save $2.37 in income and excess profits taxes, thus making a net profit of $1.37 after payment of interest. Money borrowed at 2% and 3% will give the company net profits of $0.74 and $0.11 respectively. For a discussion of when it is advantageous to borrow, see Lasser, *The Cost of Borrowing Money*. BANKING (Jan. 1941) 28-29. If the statute is read literally, corporations might be able to lend back and forth in order to profit from tax savings, but it is doubtful that the courts would permit such a loophole. Seidman, *supra* note 41, at 700.

82. SHOUP, *supra* note 17, at 90-92, argues that complete inclusion of borrowed capital is not feasible while admitting the force of arguments against complete exclusion. The argument for inclusion is that the risk is increased when there is borrowed capital. But the reply to this is that returns on equity capital become excessive when corporations earn more than the interest rate if they are permitted to earn tax-free on borrowed capital more than the interest rate. See Buehler, *The Excess Profits Tax* (1941) 214 ANNALS 86, 90. A suggestion has been made to solve the problem by drawing an arbitrary distinction: if the interest is over 5% include it as equity capital; if the interest is under 5% treat it as a creditor capital and exclude it entirely. Hynning, *supra* note 16, at 470.

83. Preferred stock, because of its fixed dividend rate, presents a problem comparable to that of borrowed capital. Complete inclusion will stimulate the use of preferred issues as it did in the last war. The ideal scheme would delimit the tax-free return on low dividend preferred shares but, for practical reasons, full inclusion must be allowed as in the present Act. See SHOUP, *supra* note 17, at 92-95.

Accumulated deficits are not deducted in computing invested capital.[84] If deficits result from temporary operating losses, such treatment is defensible. But, if the deficits constitute a permanent reduction of the capital of the business, failure to deduct them from invested capital results in discrimination against competitors. Such favorable treatment of deficits should create a lively market for unsuccessful companies.[85] Earning of tax-free returns on non-existent capital should be eliminated by compulsory deduction of deficits from invested capital.[86]

Included in invested capital under the present Act are accumulated earnings and profits at the beginning of the taxable year.[87] This acts as an encouragement for companies to retain earnings in order to enlarge invested capital for the ensuing year. Retention of earnings causes the Government to lose revenue at two points: first, corporations increase their invested capital credit under the excess profits tax and, second, stockholders pay no personal income tax on undistributed earnings. Encouragement to retain corporate earnings is thus a reversal of the hostility of the present administration to such practice.[88] Congress attempted to discourage this practice by providing that earnings not retained for at least sixty days of the taxable year should be treated as though they had been distributed on the last day of the preceding year.[89] Since revenue losses are so serious, it would be wiser to limit increases in invested capital after the base years to capital actually paid in.[90]

Although inadmissible assets such as stock in other corporations and tax-free securities[91] are not directly deductible from invested capital, invested

84. § 718 relates back to what was originally paid in and makes no provision for capital lost since then. This is a result of valuing from the liability side and would not occur in Great Britain. See note 64 *supra*.

85. Stock control of such a company could be easily secured and profits could be diverted to it in order to take advantage of its previous invested capital. To a lesser degree, a similar demand for companies which have good base period records but subsequently declined might arise under the income credit. SHOUP, *supra* note 17, at 544.

86. Although this would seem unduly harsh upon stockholders who paid in the original capital and would not be permitted to recoup their losses, few of the original stockholders would still be such. The present Act really gives a windfall to stockholders who purchase later.

87. § 718(a)(4). Accumulated earnings and profits during the taxable year are not included.

88. See especially, Undistributed Profits Tax and INT. REV. CODE § 102 (1939).

89. § 718(c)(2). Rather than discouraging retention of earnings, this actually caused delay in first quarter dividends of this year. See Wall Street Journal, Jan. 9, 1941, p. 1, col. 1; BUSINESS WEEK (Jan. 25, 1941) 50-51.

90. This would not hit corporations so hard as the undistributed profits tax since they would be allowed to retain earnings but would not be permitted to earn a tax-free return on them.

91. § 720(a). Tax-free securities are described in INT. REV. CODE § 22(b)(4) (1939). Stocks listed in inadmissible assets include neither stock in foreign personal-holding companies nor stock which is not a capital asset. § 720(a)(1)(A). Income from these stocks

capital is reduced by the percentage which such assets bear to total assets.[92] The effect of this is to apportion inadmissibles between equity and borrowed capital.[93] Since the purpose of the provision is to exclude from invested capital any capital used to produce tax-free income, none of the inadmissibles should be ascribed to borrow capital which is allowed to earn the amount of the interest tax-free and the full amount of the inadmissibles should be deducted directly from equity capital. Furthermore, since the income tax gives a credit of 85 per cent against dividends received,[94] it would be more consistent to include 15 per cent of the dividends received in excess profits net income and include 15 per cent of these stocks in invested capital.

If income from tax-exempt securities is included in normal-tax net income for the taxable year, at the option of the taxpayer, the securities may be included in invested capital.[95] By agreeing to let his 2 or 3 per cent interest received be taxed, the taxpayer gets a credit of 8 per cent so that he can earn 5 or 6 per cent more on the amount of those securities free from the excess profits tax.[96] The only possible purpose served by this special bonus is promotion of the sale of federal obligations so extensively used in financing defense spending.[97] But to be consistent with this purpose it would seem that the bonus should be restricted to federal obligations and not extended to all tax-free securities.[98]

Conclusion

Although the selection and determination of a sound credit is the critical step in the process of devising a successful emergency excess profits tax, the drafting of a new Act will further require the solution of many other minor problems not within the scope of this Comment. Among them, for example,

is fully deducted in order to reach excess profits net income. When the income credit is used the deduction is only for dividends from domestic corporations. § 711 (a) (1) (F). But under the invested capital credit, the deduction is for dividends from all corporations. § 711 (a) (2) (A). Dividends from domestic corporations are also deducted from base period income. § 711 (b) (1) (G).

92. § 720(b). The 1918 Act treated inadmissibles in the same way. §§ 325(a), 326(c).

93. Companies a large part of whose capital was borrowed would thus have a smaller deduction for inadmissibles than those which had entirely equity capital since only the inadmissibles ascribed to invested capital are deducted.

94. Int. Rev. Code § 26(b) (1939).

95. Section 720(d).

96. For a computation of the saving that can be effected by making this election, see Hynning, *supra* note 16, at 461.

97. The House bill included all tax-exempt securities in inadmissible assets, but the Senate bill introduced the election for tax-exempts. Senate Report, p. 6; Conference Report, p. 50.

98. Whether even federal obligations should be given this bonus is doubtful since it weakens the tax but certainly other tax-exempts, already favored under our tax system, should receive no further premium. See Hynning, *op. cit. supra* note 16 at 470.

are the formulation of relief[99] and exchange[100] provisions, the selection of taxable units,[101] and the construction of rate schedules.[102]

The present Act with its emphasis on preserving the taxpayer from hardship will inevitably be revised to meet the urgent need for more war revenue.[103] Recently reported Treasury proposals call for an increase in revenue either by raising the present rates or lowering the amounts of

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99. The general provisions of an excess profits tax will be inequitable in many cases unless special provision is made for unusual situations. In order not to be administratively cumbersome, as many of these unusual cases as possible should be foreseen and specifically provided for but it is probably impossible to escape from a general relief provision. The present Act has attempted to foresee and provide for as many of these unusual cases as possible but it appears to have stressed relief for the income credit over relief for the invested capital credit. The most liberal relief provision is, of course, the optional credit. When this option is eliminated, more care must be taken in providing for abnormal cases, especially in the determination of invested capital. The famous §§ 327, 328 of the 1918 Act were much more liberal than anything in the present Act since a corporation could have its tax reduced to the average of representative corporations in the same business. It is unlikely that anything which eliminates competitive differences as these provisions did would be desirable. For a discussion of relief provisions in the present Act see 50 YALE L. J. 285, 303-4; Turner, *Abnormalities in Invested Capital and Income and Effect of Specific Relief Provisions of the Second Revenue Act of 1940* (1941) 71 J. ACCTY. 229; Magill, *Relief From Excess Profits Tax* (1941) 89 U. OF PA. L. REV. 843.

100. Exchange provisions are necessary in order to determine the income credit and invested capital of acquiring corporations. See §§ 740-52; 50 YALE L. J. 285, 297-303; Seidman, *Exchange Provisions of the Excess Profits Tax Law* (1941) 71 J. ACCTY. 7.

101. The present Act gives corporations the option of filing individual or consolidated returns. § 730. See U. S. Treas. Reg. 110; Cooper, *Consolidated Excess Profits Tax Returns* (1941) 71 J. ACCTY. 391. Corporations will naturally select the one resulting in the lower tax. Mandatory consolidated returns are particularly necessary under the present Act which illogically graduates the tax by dollar brackets (§ 710(a)) so that spreading of income among affiliates can reduce the total tax. Even if this undesirable feature were eliminated, compulsory consolidated returns would probably be advisable because it would be more equitable than taxing the profitable members without allowing deductions for losses of other members of the joint undertaking and evasion would be prevented. But see Hynning, *supra* note 16, at 463, 467. Shoup, *supra* note 17, at 100-2, and Twentieth Century Fund, *op. cit. supra* note 31, at 278-79, recommended that the tax be applied to units even smaller than the individual company. The 1917 Act did not require consolidated returns but it was found necessary to require them by regulation (U. S. Treas. Reg. 41, Art. 78) and they were made mandatory in the 1918 Act (§ 240).

102. The size of the tax rate depends, of course, on the amount of revenue desired but it should undoubtedly be high. The three credit proposals made above included suggestions as to the type of tax — flat or graduated — but whatever credit is used, the tax should not be graduated by dollar brackets. § 710(a). Such a method of graduation makes the tax a penalty surtax on large corporations. See Hynning, *supra* note 16, at 446. It deprives the government of revenue and makes a farce out of the goal of preventing war profiteering, except in the case of large corporations.

103. The Treasury has asked Congress for $3,444,000,000 of new revenue. N. Y. Times, April 18, 1941, p. 1, col. 1.